CROSSMARK GLOBAL INVESTMENTS

Doll's Deliberations

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SUMMARY:

U.S. equities were higher last week (S&P 500 +2.4%) more than erasing the prior week's declines. The small-cap R2000 increased 3.6%. The main focus for the week was the June CPI report, which came in softer than consensus on both the headline and core readings. Best sectors were communication services (+3.4%) and consumer discretionary (+3.3%); worst sectors were energy (+0.6%) and consumer staples (+1.2%).

KEY TAKEAWAYS:

1. June CPI report showed a cooling in inflation. Headline inflation increased 0.2% m/m (3.0% y/y). Core inflation was up only 0.2% m/m (and still a too high 4.8% y/y). The Fed is still likely to raise rates by 25 basis points this month, but could pause again in September.

2. The June payroll report was the first in 15 months that did not exceed expectations (and included more than 100,000 negative revisions from prior months). Average hourly earnings increased 0.4% m/m (the strongest since last July) and 4.4% y/y.

3. Credit spreads remain below recessionary levels (currently 380 basis points (lowest level since before the spring banking crisis))vs. 600 basis point at the start of recessions.

4. Earnings season started with big banks generally reporting strong results.

5. Full year S&P 500 estimates are falling again. 2023 estimates (which started the year at $232) are down to $220 and 2024 estimates now are at $246, the lowest level yet.

6. The largest ten companies in the S&P 500 (Apple, Microsoft, Google, Amazon, Nvidia, Tesla, Berkshire Hathaway, Meta, United Health, and Lilly) make up 30% of the capitalization of the index, but only 20% of the earnings.

7. Expectations for stock prices to increase reached their highest level since December 2021 (June Consumer Confidence Survey). Retail investors are jumping on the bandwagon and FOMO is helping to drive the market higher.

8. Investors continue to bet that the Fed will stop raising rates soon, will be able to cut rates meaningfully in the year ahead, while bringing down inflation close to target, all the while sustaining economic expansion. In our view, "that needle is too difficult to thread."

9. Elections Factoid: Every president who avoided a recession two years before their re-election went on to win. And every president who had a recession in the two years before their re-election went on to lose.

10. Although the economy is doing pretty well, the yield curve remains deeply inverted, the money supply is shrinking, corporate profits have peaked, banks are tightening their lending standards, the Fed has raised rates 500 basis points in just over a year and threatens to do more, liquidity conditions are not good, and stocks are not cheap. As such, we expect an economic slowdown, earnings cuts, and possibly a recession. Stock selection requires quality, ability to deliver earnings and cash flow, and reasonable valuations.

EQUITY MARKETS (INDEX TOTAL RETURN)	LAST WEEK	YEAR-TO-DATE
DJIA	2.29%	5.30%
S&P 500	2.44%	18.41%
NASDAQ	3.32%	35.47%
RUSSELL 2000	4.64%	11.68%
RUSSELL 1000 GROWTH	3.22%	31.71%
RUSSELL 1000 VALUE	1.87%	5.96%

S&P EQUITY SECTORS (INDEX TOTAL RETURN)	LAST WEEK	YEAR-TO-DATE
COMMUNICATION SERVICES	3.36%	40.64%
CONSUMER DISCRETIONARY	3.31%	37.03%
CONSUMER STAPLES	1.21%	1.41%
ENERGY	0.62%	-5.57%
FINANCIALS	1.98%	1.06%
HEALTHCARE	2.11%	-2.27%
INDUSTRIALS	2.22%	11.47%
INFORMATION TECHNOLOGY	2.81%	44.67%
MATERIALS	2.50%	8.22%
REAL ESTATE	2.66%	6.79%
UTILITIES	2.26%	-3.68%

INTERNATIONAL EQUITY MARKETS (INDEX NET RETURN)	LAST WEEK	YEAR-TO-DATE
MSCI ACWI	3.37%	16.21%
MSCI ACWI EX U.S.	4.45%	12.45%
MSCI EAFE	4.69%	14.52%
MSCI EM	4.13%	8.52%

BETTER INFLATION NEWS, BUT....

A soft inflation report last week halted the upward grind in government bond yields that were on the verge of setting new cycle highs. The global economic expansion, while slowing, certainly continues, probably making bond yield easing limited/ temporary. Such market action is working at cross-purposes to central banks' desire to slow growth and engineer some labor market slack, which is critical to both sustaining disinflation, and ensuring that inflation does not quickly revive after the next growth phase takes hold.

In the near-run, any relief in bond yields is welcomed by equity bulls, who celebrate whenever the probability of monetary policy overkill is perceived to have declined. Calm bond markets are critical for equity markets because all of the gains since the October low were due to a re-rating of stocks. For now, bond yields have backed off, although the short end of government yield curves are still close to new cycle highs in the U.S. and euro area. While year-on-year inflation has continued to steadily retreat as expected, we foresee core inflation measures levelling at levels that will be well above those recorded pre-pandemic. In other words, underlying inflation will be too high for central banks to start cutting policy rates any time soon.

The implication is that there may be more policy rate hikes ahead and higher bond yields, assuming the Fed is serious about bringing down inflation to the 2% area and maintaining a low inflation backdrop. There is a strong belief among central banks and bond bulls that the rise in inflation in the past two years was solely due to a series of one-off shocks caused mostly by the pandemic, with the war in Ukraine contributing as well. We continue to disagree with this "transitory" view. The unprecedented fiscal and monetary stimulus in 2020-2022, combined with these one-off pandemic-related effects, caused a huge rise in inflation and generated extremely tight labor markets. The revival in long dormant wage demands (and now increased strike action) and the boost to longer-term inflation expectations underscore that returning to a 2% inflation world will entail a "cleansing" downturn, i.e., a recession. In other words, economic slack must be created and then persist for some time.

The outlook for equities remains tricky, with near-run forces being supportive, but the cyclical outlook troublesome given valuation levels and earnings risk. Despite some recent broadening, the thin nature of the global advance in equities this year dominated by massive gains in a handful of U.S. mega-cap tech and related stocks, remains a concern. We caution against chasing richly-priced assets, while remaining tactical flexibility with an overweight in cash.

FIXED INCOME MARKETS (INDEX TOTAL RETURN)	LAST WEEK	YEAR-TO-DATE
BLOOMBERG U.S. AGGREGATE BOND	1.93%	2.72%
BLOOMBERG U.S. CORP HIGH YIELD	1.78%	6.61%
BLOOMBERG U.S. GOV/ CREDIT	1.84%	2.78%
BLOOMBERG U.S. T-BILL 1-3 MONTH	0.09%	2.52%

ALTERNATIVES (INDEX TOTAL RETURN)	LAST WEEK	YEAR-TO-DATE
REAL ESTATE (FTSE NAREIT)	2.81%	6.30%
COMMODITIES (DJ)	2.74%	-4.76%
GLOBAL LISTED PRIVATE EQUITY (RED ROCKS)	6.13%	18.92%
CURRENCIES (DB CURRENCY FUTURE HARVEST)	-0.88%	4.53%

The U.S. dollar has once again lost momentum, and is at a 15-month low. Conversely, the euro is at a 17-month high, boosted by prospects of more ECB policy rate hikes relative to those of the Fed.

CONCLUSION:

Prolonging the economic expansion in the hopes of a relatively painless return to a 2% inflation world risks further entrenching the inflationary process, making it much more difficult to permanently lower and hold down inflation. From a cyclical perspective (6-12 months and longer), there is a risk that monetary policy will need to become fully restrictive. This, in turn, warrants staying cyclically cautious on bonds, neutral on equities with a downgrade bias, and overweight cash.

Data from Bloomberg, as of 7/14/2023.

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